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SUBJECT: INVESTING IN ICELAND: OPPORTUNITIES AND OBSTACLES

REF: Reykjavik 176

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¶1. (SBU) Summary: As Iceland struggles to rebound from last year's financial meltdown, the government is reevaluating the future direction of the country, including the role of foreign direct investment (FDI). There is potential for investment in a variety of sectors, particularly those that utilize green energy. The government has stated its desire to bring in FDI to create jobs and rebuild the economy, yet recent actions have begun to discourage foreign investors from entering the market or expanding operations. Creating and adhering to business-friendly tax policies will encourage more FDI. End summary.

#### Opportunities

¶2. (U) Katrin Juliusdottir, Iceland's Minister of Industry (SDA), recently opened a conference on FDI with her thoughts on why investors are attracted to Iceland. Investors, she said, come to the country to take advantage of Iceland's abundance of clean energy, educated population, and geographic location. She added, however, that Iceland must diversify its economy if it intends to create a sustainable and competitive financial system. The country has identified several fields on which it is concentrating efforts, but is open to any idea that would utilize the country's resources in a profitable, environmentally responsible manner.

¶3. (SBU) Several government leaders, including three Ministers, have told us that they view data centers as a key to the development future of Iceland. Data centers are an ideal industry for Iceland due to the country's naturally cool climate and low utility costs. According to the director of the government-sponsored Invest in Iceland Agency, data centers that invest in Iceland can negotiate power supply prices for 20 years. This could lead to savings of up to 40 percent per year on energy costs compared to data centers in London. As a result of these advantages, several data center firms are looking at Iceland, including an American company that is rumored to have lined up IBM as a client.

¶4. (U) The government of Iceland is also actively trying to attract FDI in the field of health tourism. An American-financed company is planning to open a private hospital outside of Reykjavik that will specialize in hip and knee surgeries for foreigners. Invest in Iceland is also seeking investors for carbon fiber production, utilizing the energy stream from geothermal plants to power greenhouses, cultivation of aquatic biomass, and polysilicon production. Similarly, the property manager of the old NATO base in Keflavik is actively seeking businesses to set up operations. It is focusing on areas such as data centers, a renewable energy research center, health tourism and a flight school, but is flexible and open

to other industries. The area is close to the international airport and a harbor and has access to renewable energy.

#### Obstacles

15. (SBU) A major obstacle to investing in Iceland is the uncertainty created in the fallout of last year's financial crisis. The representative of one of the first companies trying to open a data center in Iceland noted at the recent FDI conference that the country is perceived as a risky place to do business as a result of last year's financial meltdown, the Icesave issue, and the ongoing currency restrictions. Capital controls remain in effect, though it is anticipated that the Central Bank will begin gradually lifting the restrictions upon receipt of the next tranche from the IMF. The managing director of the McDonald's franchise in Iceland announced the closure of all three restaurants effective November 1, citing the rising cost of importing ingredients and the lack of any signs of an economic recovery.

16. (U) A second obstacle is Iceland's evolving tax structure. Fred Vossen, a partner with PriceWaterhouseCoopers in Belgium, stated at the FDI conference that the lack of certainty regarding the tax environment impedes investment. The government currently views increasing tax revenue as one of its few options in the struggle to reduce the record deficit that is projected to exceed 10% of GDP in 2010. Vossen argued that a proposed uniform energy tax (reftel) would kill Iceland's national competitive advantage in energy intensive industries. Media reports indicate that foreign companies have already halted at least seven different projects after learning about the proposed energy tax and are looking to establish operations in other countries.

17. (SBU) The data center representative agreed with Voss, noting that the uncertainty surrounding tax issues is the number one problem today. Despite Iceland's stated desire to attract data centers, for example, its prospective tax policy could produce the exact opposite effect. (Note: In addition to taxing the data center itself, the Ministry of Finance is considering classifying each server as a physical presence in Iceland, which would subject each data center client to additional taxation. End note.)

18. (U) Another potential obstacle to foreign investment is a rising nationalistic movement in Iceland. A growing number of Icelanders are increasingly wary of foreign investors and deeply protective of maintaining ownership of Iceland's natural resources. The government has stated that it would also like to diversify the economy beyond the aluminum and fishing industries. As a result, aluminum projects planned years ago have been delayed or canceled. For example, the Minister of Environment did not renew a letter of intent for the construction of an American smelter in the north to allow the government to investigate more environmentally friendly options that could create more jobs or income. (Note: It is perceived that the long-term contracts negotiated by the aluminum industry contain unfavorable terms for the government, particularly regarding the cost of energy usage. End note.) The Minister of Environment also called for a review of an environmental impact assessment for another American aluminum smelter near Keflavik already under construction. Her decision could delay the project anywhere from two months to two years and raises the question of whether Iceland will honor previous commitments to foreign firms.

#### Comment

19. (SBU) The Minister of Industry recognizes that FDI is a key element in creating jobs and rebuilding Iceland's economy; however, she faces some strong opposition in creating such a reality, especially from the minority members of the ruling coalition. The potential exists for FDI in Iceland, ranging from small business to large scale investment. Yet the debate regarding the appropriate types and level of FDI in Iceland must be resolved in short order for Iceland to restore its credibility in the international business community. Implementing a business-friendly tax policy is the first step, which the government must do in consultation with key industry players. Iceland should also create an incentive package for inward investment that is in line with EU regulations, to include tax incentives, training grants, and cash grants for fixed asset investments. However, since the government has yet to fully grasp

the importance of implementing such measures, a comprehensive investment strategy including such incentives is unlikely to materialize any time soon. End comment.